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The Below-Cost Test in Agricultural Antidumping Cases

Proposals for Discussion

Ministry of International and Intergovernmental Relations

Government of Alberta, Canada

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INFORMATION BULLETIN

Alberta Proposals for the Reform of Anti-Dumping Rules

The issue of trade remedies (i.e., countervail and anti-dumping) is a critical component of the current round of trade negotiations in the World Trade Organization (WTO).

The Government of Alberta believes that it is essential to consider the relationship of trade remedies to international competitiveness and the economic changes brought about by globalization. Current trade remedy systems are deeply flawed, and one of the goals of trade policy should be to work toward the fundamental reform of anti-dumping and countervail in the context of continued market liberalization. Canada's trade policies must be focused on the future, and must give producers and consumers the tools necessary to adapt and prosper in a rapidly-changing world. This will not happen if trade rules interfere with the efforts of producers and consumers to respond to market signals and interfere with normal competitive activity.

In 2000, based on Alberta's experiences in agricultural trade cases, the province considered what changes could be made to make the operation of antidumping rules fairer in the agricultural sector, particularly for cyclical industries. The Alberta discussion paper, developed in consultation with the law firm of Arnold & Porter of Washington, D.C., counsel for the Government of Alberta, can be found at: http://www.iir.gov.ab.ca/trade_policy/pdfs/2.4f.12b-AgProducts_Antidumping_Sept00.pdf.

In 2002, working again with Arnold & Porter, Alberta developed additional proposals covering both the WTO Subsidies and Antidumping Agreements. These proposals cover a range of options from policy changes to specific changes in the application of countervailing and antidumping measures. That paper can be found at: http://www.iir.gov.ab.ca/trade_policy/pdfs/WTO_subsidies_antidumping_proposals_Oct02.pdf.

The current paper returns to the theme of anti-dumping rules and agriculture, first raised in the 2000 paper. The 2000 paper noted the pernicious impact of the "below-cost" test for cyclical agricultural products caught up in anti-dumping investigations. In cooperation with Arnold & Porter, we explore this issue further and offer several suggestions for reform. While our ultimate objective is to see fundamental reforms to trade remedy regimes, making them consistent with the principle of "national treatment", the unique characteristics of agriculture present opportunities for more immediate changes.

ARNOLD & PORTER LLP

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Memorandum

To: Government of Alberta

From: Arnold & Porter

Date: December 10, 2004

Re: U.S. Application of Below-Cost Test in Agricultural Antidumping Cases

I. CURRENT WTO REQUIREMENTS REGARDING BELOW-COST TESTS

Under the WTO Antidumping Agreement,[1] a product is considered dumped if the price of the product, when exported from one country to another, is less than its "normal value." The "normal value" generally is the comparable price, in the ordinary course of trade, for the like product when destined for domestic consumption in the exporting country, or, if such sales are insufficient, in an appropriate third country. *See Antidumping Agreement*, Articles 2.1 and 2.2.

Calculation of the margin of dumping also can involve application of a below-cost test. That is, under certain circumstances, below-cost home market/third-country sales can be excluded in calculating the normal value. The exclusion of below-cost sales is provided for in Article 2.2.1 of the Antidumping Agreement, which states as follows:

> "Sales of the like product in the domestic market of the exporting country or sales to a third country at prices below per unit (fixed and variable) costs of production plus

[1] Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994.

> administrative, selling and general costs may be treated as not being in the ordinary course of trade by reason of price and may be disregarded in determining normal value only if the authorities determine that such sales are made within an extended period of time in substantial quantities and are at prices which do not provide for the recovery of all costs within a reasonable period of time. If prices which are below per unit costs at the time of sale are above weighted average per unit costs for the period of investigation, such prices shall be considered to provide for recovery of costs within a reasonable period of time." Art. 2.2.1.

The paragraph further provides that the "extended period of time" "should normally be one year but shall in no case be less than six months." Art. 2.2.1, note 4. Sales below cost are made in "substantial quantities," "when the authorities establish the weighted average selling price of the transactions under consideration for the determination of normal value is below the weighted average per unit costs, or that the volume of sales below per unit cost represents not less than 20% of the volume sold in transactions under consideration for the determination of the normal value." Art. 2.2.1, note 5.

The practical effect of applying the below-cost test is to broaden the concept of dumping beyond international price discrimination. Specifically, eliminating below-cost sales in the comparison market from the calculation of normal value increases the weighted average price of the remaining sales and thereby increases normal value. Thus, all other things remaining equal, the exclusion of below-cost sales has the effect of increasing dumping margins. The rationale for this exclusionary policy seems to be either that it will ensure companies are not engaged in predatory pricing below cost in an effort to drive competitors out of business, or that dumping simply should include below cost sales.

Significantly, under the Antidumping Agreement, not all below cost sales are excludable. Through the "substantial quantities" and "extended period of time" tests outlined above, the *Antidumping Agreement* implicitly recognizes that some below-cost sales should not be removed from price calculations, because they are normal and necessary. For example, end of model year products and older inventory frequently must be sold at below cost prices to make way for new goods. Thus, when below-cost prices do not occur in substantial quantities or over an extended period of time, the *Agreement* does not permit their exclusion in the dumping calculations. The *Agreement* recognizes that antidumping comparisons would be distorted, and dumping margins artificially created, if normal below cost sales were excluded in computing the normal value.

These provisions concerning the retention of below-cost rates in normal value calculations could be improved, however. For example, the *Antidumping Agreement*'s definitions of "extended period of time" and "substantial quantities" do not attempt to take into account the particular characteristics of the product and industry being investigated, because they do not examine the level of below-cost sales that would be normal or necessary in the particular situation under scrutiny. Instead, the current text contains inherently arbitrary tests, defining "substantial quantities" with a rigid 20 percent test, and providing that the "extended period time" should not exceed one year.

This inflexibility in defining excludable below-cost sales is mitigated somewhat by the fact that the *Antidumping Agreement* plainly gives the investigating authority the discretion to retain or to exclude below-cost sales, even if they are made in substantial quantities over an extended period of time. The *Agreement* provides that the administering authority "may" treat below-cost sales as not being in the ordinary course

of trade, and "may" disregard below-cost sales in computing normal value. This means that the authority also may leave these rates in its computation.

However, given that administering authorities have a natural tendency to favor their domestic producers in any area where they have discretion to do so, it is important to add discipline to this analysis, so that it is even-handed. Currently, the Agreement does not define the circumstances under which it would be appropriate or inappropriate to exclude below-cost sales or mandate any analysis by the administering authority of the proper way to handle particular sales or industry pricing cycles. The present text permits the exclusion of below-cost sales whenever the minimum requirements of Art. 2.2.1 are met, and this creates ample opportunities for protectionist influences in an importing country to require virtually automatic exclusion of below-cost sales.

II. CURRENT UNITED STATES IMPLEMENTATION OF *BELOW*-COST TEST

In practice, the United States has implemented the below-cost test without exercising the discretion Article 2.2.1 conveys to leave below-cost sales in the normal value calculation. *First*, the United States almost always treats below-cost sales meeting the substantial quantities test as being outside the ordinary course of trade, and excludes them from the computation of normal value.[2] *Second*, the United States has implemented the two tests for "substantial quantities" so as to restrict the applicability of the less restrictive, weighted average test in favor of the more restrictive 20 percent volume test. The United States applies the 20 percent volume test to all products except highly

[2] The "extended period of time" test has no independent application in U.S. practice, as the United States normally will use a one-year period of investigation. The United States applies the 20 percent test to this one-year period as a whole.

perishable agricultural products, to which it applies the weighted average per unit price to cost test.[3]

Third, the United States applies both the below-cost test and the substantial quantities test on a model-specific basis. Thus, in an investigation involving a hundred different models or product types, if 20 percent of the volume of model type is found to be below the cost of production for that model type, the United States will disregard those sales regardless of whether or not 20 percent of the volume of the like product as a whole is sold below the cost of production.

Fourth, the United States calculates and allocates costs in ways that increase the likelihood of below-cost sales.

Fifth, after excluding below-cost comparison market sales, the United States will base normal value on the remaining comparison market sales, no matter how few of these sales exist or how unrepresentative the remaining prices may be. For example, if all but one sale of a model in the comparison market is determined to be below the cost of production, the United States will continue to base normal value on the one remaining sale.

Finally, where the United States' below-cost test eliminates all domestic sales of a model or models, so the U.S. must calculate a "constructed value" for normal value, the U.S. requires this constructed value to incorporate a profit, even if no one in the industry is making any profit at the time.

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[3] The United States further defines highly perishable agricultural products restrictively. For example, the United States has determined that fresh roses constitute a highly perishable product, but that fresh salmon does not.

III. PROBLEMS ARISING FOR AGRICULTURAL INDUSTRIES

A. The Nature of Agriculture

The United States' approach yields harsh and unfair consequences for certain agricultural industries. A traditional dumping investigation involves a manufactured product in an industry where there are relatively small numbers of foreign producers and competing U.S. producers. Each producer sells a branded or otherwise differentiated product, and has some ability to set prices. The cost of production can be calculated easily, because the manufacturer usually uses model-specific cost accounting. Different products can be assigned different costs because different component materials and/or processing methods are used. Prices tend to be relatively stable, since there is little seasonality, and producers can react to short-term changes in demand by varying production and/or inventory.

Agricultural industries differ from manufacturing industries in important respects. This is particularly true with regard to the production of unprocessed, direct farm or fishery products. The number of producers in the industry can be very large, and the industry can be highly fragmented, in both the producing and importing country. Also, the production cycle can be lengthy. For example, crops will take months to grow and harvest, cattle and swine will take years to grow from birth to market weight, and farmed salmon will take about three years for the fertilized egg to mature into a marketable product.

As a result of these two factors alone, individual producers are more likely not to have control over prices, but rather are classic price takers in economic terms. Indeed, they may sell through auctions or may respond to bids by major purchasers. Even in

agricultural industries where the number of producers is relatively small, an individual producer may, in practical terms, have little control over prices due the high perishability of its product, and/or the inability to increase or decrease product in the short-term due to the lengthy production cycle.

Whereas a manufacturer can simply purchase fewer inputs or idle capacity in the face of short-term declines in demand, an agricultural producer may have no such flexibility. The flower must be cut or it will perish. The wheat and corn must be cut before they spoil. Livestock continue to grow, regardless of short-term demand fluctuations. As a result, the supply of agricultural products on the market during a given, often multi-year period, cannot change significantly, whether the prices are high or low. This, in turn, means that agricultural producers do not pose the threat of deliberate price cutting behavior which seems to be the justification for the below-cost sale exclusion rate.

The calculation of an accurate cost of production for individual "models" of an agricultural product also may be impossible. "Model" differences in agricultural products tend to revolve around size or quality/grade differences, which generally are not reflected in computable differences in the particular "models'" costs of production. For example, a salmon farmer will obtain different prices in the market per kilogram for salmon of different quality and size, yet will not be able to point to different costs incurred to produce its different grade and size salmon. A mushroom grower will obtain different prices in the market for different size mushrooms, but all are jointly produced in the same production processing using the same materials and processing.

The joint production of high and low value products can cause the low value products to be charged with one average cost that will be higher than warranted, given the product's market value. This in turn can result in lower value products being eliminated from normal value calculations, as below cost, which will result in an antidumping analysis for those products that is not based on real market prices for that kind of goods. Inevitably, this analysis raises the dumping margin.

In addition, prices for agricultural products may be cyclical, seasonal, or otherwise fluctuate greatly. For example, certain agricultural products may have historical boom and bust pricing cycles, such as the well-recognized multi-year hog and cattle cycles in North America, where producers expand herds as prices increase. Then, the resulting production increases cause prices to fall, which results in herd contraction and then increasing prices. Likewise, prices may be subject to regular seasonal fluctuation, due to recurring supply or demand variations. Overall, when the pricing is reviewed over the industry's cycle, it generates profits. However, at certain points, it may be well known that all producers are losing money.

Agricultural products also tend to be commodities, with little or no branding or other differentiation among the products produced and sold in different countries. Barriers to entry also tend to be low. These factors tend to increase price volatility as demand, and to a lesser extent, supply, can fluctuate greatly.

B. The Implications for Computing Production Costs and Testing for Below Cost Sales

These attributes of agricultural products and industries can distort the antidumping analysis if traditional below-cost methodologies are applied inflexibly, as

permitted under the current terms of the *Antidumping Agreement* and as under current United States practice. For example,

- The number of below cost sales that are normal and necessary will tend to be higher for agricultural products than for manufactured products, yet the current *Agreement* applies the same "substantial quantities" test to all products. The high perishability of certain agricultural products, and/or the inability to control production in the short-term, may mean that producers have no choice but to continue producing and selling their products, even under poor market conditions and declining prices, because they cannot decrease production in response to short-term price declines. Below cost sales are not simply a matter of model closeouts, and thus the 20 percent test is ill suited for agricultural products.

- The lengthy production cycle means that below cost sales may be normal and necessary for longer periods of time than for manufactured products. Additionally, the existence of boom and bust seasonal pricing cycles can make it necessary for producer to sell at below-cost prices for extended period of times during the down phase of the cycle, whereas average prices may be above cost over the entire cycle. This cycle, moreover, is likely to last well beyond the one-year period contemplated in the current *Agreement*. Thus, the current definition of "extended period of time" is too restrictive.

- The degree and extent of below-cost sales can be exaggerated where models are differentiated based on physical characteristics for which cost of production differences cannot be calculated. Invariably, many more sales of the lower grade, smaller size, lower value size merchandise will be found to be below-cost, increasing the margin of dumping found for those models. But this is a false, mismatched comparison, as an average cost of production across all models cannot meaningfully be compared to prices for individual models. Plainly, not all models, and not all grades and sizes of a product, can be above average.

- Accurate costs of production that match sales during the investigated period also may be difficult to compute for small agricultural producers. Many family farms use cash basis rather than accrual accounting, which can lead to distortions in the calculation of a cost of production. This can lead to a serious mismatch between the costs calculated for the investigated period and the actual costs attributable to production in that period. Similarly, family members may provide uncompensated labor. Should such labor be counted as a production cost, when no actual cost is incurred? If so, how should a value be attributed, particularly when farmers in the export market are behaving exactly the same way? The current *Agreement* fails to address these issues, but the United States requires "market" labor costs to be imputed and does not adjust for cost distortions created by lack of sophisticated accounting

systems.

IV. PROPOSALS FOR ADAPTING THE BELOW-COST TEST TO THE REALITIES OF AGRICULTURAL PRODUCTS AND MARKETS

If investigating authorities implemented the below cost test with the flexibility already built into the *Antidumping Agreement*, there would be no problem. As noted, the Agreement does not compel investigating authorities to exclude below-cost sales. Nor does the Agreement compel investigating authorities to limit the extended period of time over which cost and prices are analyzed to one year. Finally, the Agreement does not compel investigating authorities to use the 20 percent volume test in all cases. Nevertheless, it imposes no restrictions on doing so, and, as noted, this has been the practice of such countries as the United States. The result has been unfair antidumping margin calculations for certain agricultural products.

The fundamental problem in the current below-cost test is that it contains no requirement that the below-cost methodology be applied in a fashion that takes into account the particular characteristics of the industry to which the test is being applied. The premise of the "substantial quantities" test is that a certain level of below-cost sales is normal and necessary in all industries. Yet, the 20 percent test is inherently arbitrary. As noted, it may be appropriate for manufactured products, where the typical normal and necessary below-cost sales consist entirely of model closeouts. However, a 20 percent test is entirely *inappropriate* for agricultural products subject to cyclicality, seasonality in supply or demand, and/or long production cycles.

Similarly, the premise of the "extended period of time" parameter is that products may be subject to seasonal supply and demand fluctuation but that over a "reasonable"

period of time, sales on average should be made above the cost of production. It must be recognized, however, this reasonable period of time may differ from industry to industry, and particularly as between manufactured products and agricultural products.

Other problems with costs include the issues of how to allocate joint production costs fairly across high and low value end product; the problems of imputing "market" labor costs to farmers' time when the farmers in the export market do not do this; and the practical problems of dealing fairly with limited accounting records or cash basis accounting not based on generally accepted accounting principles.

Proposals for meaningful reform of the below-cost test thus must require a more flexible application, particularly for agricultural products, in recognition of the typical characteristics of agricultural products and markets. A "one size fits all" analysis for all industries and all products is inherently arbitrary.

Several such proposals follow:

1. Eliminate the Below-Cost Test Entirely for Certain Agricultural Products

As noted above, many agricultural products, particularly those that are farmed, are produced in the exporting country by thousands of producers where none has market power or the ability to control prices. For such products, it makes little sense to apply a below-cost test at all. The producer has no choice but to take the market price, even if it is below-cost. The producer cannot elect not to produce, as the crop already has been planted, or the livestock grown. In such situations, the purposes of the *Antidumping Agreement* can be achieved simply by retaining the pure, price discrimination aspect of dumping, and eliminating the below-cost component. As long as the producer is not

selling to the importing company at a price lower than it is selling in its home market or third country market, it should not be found to be dumping.

2. Modify the Substantial Quantities Test for Agricultural Products

The 20 percent volume test for "substantial quantities" plainly is an arbitrary test, intended for manufactured products, that has no inherent validity for agricultural products. It should not be applied to agricultural products. Instead, agricultural products could be made automatically subject to the alternative substantial quantities test, whereby below-cost sales are excluded in the calculation of normal value only if the weighted average cost exceeds the weighted average price over the entire extended period of time examined.

Alternatively, a higher volume-based test could be negotiated, or the requirement could be imposed that the investigating authority determine, based upon the nature of the product and market investigated, the level of below cost sales normal and necessary for that industry. Only sales above that industry specific level would be subject to elimination.

3. Extend the Extended Period of Time

In light of the lengthy production cycle for many agricultural products, the "extended period of time" over which the existence of below-cost sales is assessed may be inappropriately limited to one year. Consideration should be given to requiring an analysis over the length of the production cycle typical of the industry, or even the pricing cycle for industries typified by boom and bust cycles. We recognize, however,

that extending the period to be investigated over multiple years entails potential practical difficulties in terms of creating burdensome data requirements from producers.

4. Impose a Requirement that any Prices Used After Application of the Below-Cost Test be Representative

Given the commodity nature of most agricultural products, prices can fluctuate greatly over a period of investigation. Prices may trend upward over a period, or they may trend downward. The result of applying a below-cost test in these circumstances can be that only the highest price points in the cycle remain after below-cost sales are excluded. Yet these prices are not fairly representative of the producer's pricing in its comparison market *over the entire period of investigation*, and thus can provide an unrepresentative and inappropriate basis for normal value.

If other solutions discussed above are not adopted, correction of this problem for agricultural products may require limitations on the use of comparison market prices as the basis for normal value, when application of the below cost test leaves few remaining above cost sales. Particularly where average prices over a period of investigation are used in price-to-price comparisons, and price movements over that period were significant, there must be some requirement that the sales remaining after application of the below cost test be representative of prices over the entire period. Otherwise, a few atypical high price, high profit comparison market sales could provide an unrepresentative, unrealistic basis for normal value.

In circumstances where comparison market prices cannot be used as the basis for normal value,here again, adjustments are necessary to ensure a fair normal value. The United States' practice has been to require that constructed value include not only fully

allocated production costs but also a positive amount for profit, even where the producer has not earned a profit in its comparison market. In light of the lengthy production cycles for agricultural products, and the existence of boom and bust cycles, there may be extended periods of time when producers are unable to earn a profit in their comparison market. In such circumstances, it is unfair to calculate normal value on the basis of a constructed value that includes what is by definition an inherently arbitrary profit amount. The *Agreement* should make clear that in appropriate circumstances, the profit component of constructed value can be zero or even negative.

5. Require that Prices be Compared to Costs Only at the Level of Specificity for Which Costs can be Calculated

Obviously, the below-cost test can function as intended only if costs are computed and prices compared on the same basis. As noted above, agricultural products may be produced and sold in different grades or sizes with different values, yet the producer may be able to compute only a single average cost of production if a volume based cost calculation is used. When this average cost of production is compared to the prices for the individual grades and models, invariably the lower grade products will disproportionately be sold below their cost of production. It is a mathematical fact that not all models can be sold at above average prices.

This problem can be solved in one of two ways. *First*, the prices can be averaged so that there is a match between the basis on which costs are calculated and the basis on which prices are averaged. If only a single average cost can be calculated for all models, this single average cost should be compared only to a single average price for all models combined.

Second, it can be recognized that the different models of agricultural products produced are joint products, and the agreement can require a value-based allocation of costs rather than a volume based allocation of costs for such joint products. That is, instead of computing a single average cost based on the volume produced, the pool joint production costs for all the different models would be allocated to each in proportion to their relative values.

This well-recognized method of accounting for joint production costs recognizes that a rational producer will produce joint products as long as the combined revenue from all the joint products exceeds the total costs of production. For example, it may cost a meat packing plant $0.75 per kilogram to purchase and process a hog, yet not every kilogram of that hog has the same value. The pork tenderloin and pork chops will be sold at higher prices than the skin or the knuckle. Value-based cost allocations ensure that costs are allocated to each product in proportion to their revenue contribution. All products thus are treated as having the same profit, rather than the more valuable products showing consistently unrealistic high profits and the lower value products showing consistent losses. In the context of an antidumping analysis, the latter approach is highly distortive.

6. Consider only Variable Production Costs in the Cost of Production Analysis

Basic microeconomics teaches that a profit-maximizing producer will continue to produce and sell products as long as it can recover its marginal variable costs of production. Yet the current below-cost test compares prices to a fully-burdened cost of production that includes not only variable production costs, but also fixed manufacturing costs, and such fixed overhead costs as interest expenses and general and administrative

overhead. Economically rational, profit maximizing pricing practices thus are effectively treated as unfair international trade practices.

Therefore, consideration should be given to excluding only sales below the variable cost of production.